Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:HMT:CIN:1:POSTF-152983-02
LRAverbeck

date: 10/18/02

to: Cathy L. Dreifort

from: Associate Area Counsel
(Heavy Manufacturing and Transportation)

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subject: [redacted]
Date of Deduction of Loss

This memorandum responds to your request for assistance dated September 26, 2002. This memorandum should not be cited as precedent.

ISSUE

When may the accrual-basis taxpayer recognize a loss for amounts paid to elect the early termination of a licensing contract?

CONCLUSION

The loss may be recognized on [redacted], when notice of termination was given and the early termination fee was paid.

FACTS

On [redacted], [redacted] entered into a [redacted] agreement with [redacted] whereby the taxpayer acquired the right to use the [redacted] in an advertising campaign. [redacted] agreed to pay, and did pay, [redacted] as follows:

- [redacted]

In addition to these fees, the agreement also provided for the payment of royalties to [redacted] on premiums and merchandise.

The contract contained an early termination option which provided that either [redacted] or [redacted] could terminate the contract effective [redacted]. The option allowed [redacted] to terminate the agreement upon the following

conditions:

- [redacted]
- [redacted]

By [redacted], [redacted] had decided to discontinue the "[redacted]" advertising campaign due to a poor response. As reported in an [redacted] article in [redacted], [redacted] dropped the ad agency responsible for the "[redacted]" campaign in [redacted]. As noted above, the contract with [redacted] could not be terminated before [redacted]. By letter dated [redacted], [redacted] notified [redacted] that it had decided, by [redacted], to discontinue the "[redacted]" campaign and that it was exercising the early termination option. [redacted] submitted the $[redacted] early termination fee with the [redacted] letter.

[redacted].[1] The taxpayer set up an accrual for [redacted] for $[redacted] and deducted the entire amount. The taxpayer's reasoning for the deduction was that their asset was impaired and under GAAP rules they are permitted to take a deduction. They also took the full deduction for tax purposes, citing the impaired asset.

ANALYSIS

Treasury Regulation § 1.165-2(a) states that a loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained. Section 1.165-1(b) requires that, to be allowed as a deduction, the loss must be evidenced by closed and completed transactions fixed by identifiable events. It is well settled that, in order for an

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[1] [redacted]

abandonment loss to be deductible pursuant to section 165, there must be: (1) an intention on the part of the owner to abandon the asset, and (2) an affirmative act of abandonment. CRST, Inc. v. Commissioner, 92 T.C. 1249, 1257 (1989), citing United States v. S.S. White Dental Manufacturing Co., 274 U.S. 398 (1927).[2] Where the taxpayer has not relinquished possession of an item, there must be a concurrence of the act of abandonment and the intent to abandon, both of which must be shown from the surrounding circumstances, in order to determine if a loss has occurred in the year of the deduction. Id. Mere intention to abandon alone is not sufficient to accomplish abandonment. Id., citing A.J. Industries, Inc. v. United States, 503 F.2d 660 (9th Cir. 1974). Non-use of property is not the equivalent of abandonment. A.J. Industries, Inc., supra at 670.

I.R.C. § 461(a) provides generally that the amount of any deduction shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income. Section 461(h)(1) provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.

Section 1.461-1(a)(2) of the Treasury Regulations provides that under the accrual method of accounting, a liability is incurred and generally taken into account in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Treas. Reg. § 1.461-4(g)(1)(i) provides that in the case of liabilities described in paragraphs (g)(2) through(7) of this section, economic performance occurs when, and to the extent that, payment is made to the person to which the liability is owed.

Section 1.461-4(g)(7) provides that in the case of a taxpayer's liability for which economic performance rules are not provided elsewhere in the regulations, as is the case here, economic performance occurs as the taxpayer makes payment in satisfaction of the liability to the person to whom the liability is owed.

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[2] In the case of a tangible asset, it is widely recognized that non-use of the tangible, depreciable property is not the equivalent of abandonment, especially where the property is not disposed of and might become productive or profitable in the future.

Taking into consideration the "intent and affirmative act" requirements of Section 1.165 with the "all events" requirement of Section 1.461, we believe that the taxpayer's loss may be recognized no earlier than [redacted] when [redacted] notified [redacted] that it was exercising the early termination option and paid the early termination fee.

Although [redacted] formed its intent to abandon the agreement, and its rights under the agreement, by [redacted], it made no affirmative act of relinquishment of that right until [redacted], when it sent the letter notifying [redacted] of such intent. Until that time, [redacted] could have used the "[redacted] pursuant to the agreement. In fact, [redacted] owned, and possibly continued to distribute, [redacted]. Even if this was of little economic value to [redacted], it contradicts any act of abandonment of its rights under the contract. Thus, the requirements of Section 165 could not have been met prior to [redacted].

In addition, [redacted]'s liability for the early termination fee did not become fixed until [redacted] did, in fact, give notice of its intent to terminate the agreement. [redacted]'s total liability also was not determinable with reasonable accuracy until the contract was actually terminated. Furthermore, the all-events test could not be satisfied until the early termination fee was paid, i.e., economic performance had occurred. Thus, the all-events test of Section 1.461 could not be met until the agreement was finally terminated and the early termination fee was paid. This occurred on [redacted]. Pursuant to Section 1.461-1(a)(2), the liability must be taken into account in the taxable year in which [redacted] falls.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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By:_____
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